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US Policymakers Consider Volcker Rule Reforms; Banking Regulators Grant Temporary Relief for Certain Foreign Funds

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August 10, 2017 TO: ICI Members
ICI Global Members
Bank-Affiliated Member Advisory Committee
ICI Global Regulated Funds Committee
SEC Rules Committee RE: US Policymakers Consider Volcker Rule Reforms; Banking Regulators Grant Temporary Relief for Certain Foreign Funds

Congress enacted Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act—known as the Volcker Rule—to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain transactions or relationships. To accomplish these goals, the Volcker Rule generally prohibits banks and their affiliates and subsidiaries (referred to as "banking entities") from engaging in "proprietary trading,"[1] and from sponsoring or investing in hedge funds, private equity funds, or other similar funds (referred to as "covered funds").

There is a growing body of commentary and policymaker focus on the need for changes to the Volcker Rule, or to its implementing regulations. For example, possible improvements to the Volcker Rule were a topic of discussion at a meeting of the US Financial Stability Oversight Council (FSOC) in late July.[2] US authorities and other commentators have raised concerns about possible effects on market liquidity[3] and have suggested that the rule (or the way the rule has been applied and administered) is overly complex and excessively burdensome. Concerns also have been expressed about overbroad application of the implementing regulations to entities or vehicles the statute was not intended to capture.

This memorandum briefly describes three recent developments regarding the Volcker Rule:[4]

- An Office of the Comptroller of the Currency (OCC) notice requesting comment on the Volcker Rule;

- A statement of policy from US banking regulators providing temporary Volcker Rule relief for certain foreign funds; and
- Treasury Department recommendations for changes to the Volcker Rule.

OCC Request for Comment

In early August, the OCC issued a notice (Notice) requesting public input on how the final rule implementing the Volcker Rule should be revised to better accomplish the purposes of the statute.[5] The Notice also requests suggestions for improving the ways the final rule has been applied and administered to date. Comments are due by September 21; ICI intends to submit a comment letter focusing on issues affecting regulated funds.

The Notice identifies and poses specific questions relating to four broad areas: (1) the scope of the entities to which the final rule applies;[6] (2) the proprietary trading restrictions; (3) the covered fund restrictions; and (4) the final rule's compliance program and metrics reporting requirements. It also invites comments on all aspects of the final rule and its administration, but emphasizes that the OCC is not requesting comments on changes to the statute. The OCC notes that any revisions to the final rule would have to be undertaken jointly by all five agencies tasked with implementation of the Volcker Rule ("Agencies").[7]   The Notice indicates that the OCC "anticipates that the information solicited here—that is, information and data describing with specificity any burdens or inefficiencies resulting from the current rule and explaining how particular revisions would alleviate those burdens or inefficiencies—would be useful to inform the drafting of a proposed rule."

Banking Regulator Statement Granting Temporary Relief for "Foreign Excluded Funds"

As highlighted in the OCC's Notice, the OCC, Federal Reserve Board, and FDIC, in consultation with the SEC and CFTC, issued a statement of policy (Statement) on July 21 providing temporary relief for certain foreign funds from the Volcker Rule's requirements.[8] The need for relief arises because a non-US fund may fall within the definition of "banking entity" if a foreign banking entity has a control relationship with the fund (*e.g.*, during a seeding period, or based on the fund's corporate governance structure). In that event, the fund would be considered an "affiliate" of the foreign banking entity and therefore a banking entity itself. Consequently, the fund would be subject to all the Volcker Rule's prohibitions, including the ban on proprietary trading—an untenable result.

The Statement provides that, for a one-year period until July 21, 2018, a foreign banking entity's control relationship with a "qualifying foreign excluded fund"[9] will not subject the activities of the fund to the Volcker Rule's prohibitions. In June 2015, as we had urged, staff of the Agencies provided similar, ongoing relief to funds meeting the Volcker Rule's definition of "foreign public funds." The new, temporary relief benefits foreign banking entities offering foreign funds that—even if eligible for sale to retail investors—do not qualify as "foreign public funds" under the Volcker Rule.

Treasury Department Recommendations

In June, in response to an executive order outlining "core principles" for regulating the US financial system, the Treasury Department issued a report on banks and credit unions in which it recommended regulatory reforms relating to the US depository system.[10] Regarding the Volcker Rule, the report expresses agreement with the statute's goals but states that in its design and implementation, the Volcker Rule "has far overshot the mark."

The report makes recommendations for legislative, regulatory, and supervisory changes to improve the Volcker Rule and its implementation and administration. In summary, the recommendations include the following:

- Exempt banks with $10 billion or less in assets from the Volcker Rule;
- Exempt banks with over $10 billion in assets that do not engage in substantial trading activity from the proprietary trading prohibition;
- Improve coordination among the Agencies to ensure consistency in interpretive guidance and enforcement;
- Simplify the definition of "proprietary trading";
- Provide increased flexibility for market making;
- Reduce the burden of hedging business risks;
- Reduce the burdens of the compliance program and metrics reporting requirements;
- Focus and simplify covered funds restrictions[11]; and
- Create an off-ramp for highly capitalized banks.

Further recommendations for Volcker Rule changes may be forthcoming from the Treasury Department (or others)—for example, in additional reports Treasury plans to issue in response to the "core principles" executive order, including a report on capital markets and a report on asset management and insurance.

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endnotes

[1] There are exclusions for "permitted activities," such as market making, as defined in the statute and implementing regulations.

[2] *See* Readout of the July 28, 2017 FSOC Meeting, *available at* https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/7-28-17%20FSOC%20readout.pdf.

[3] *But see* Staff of the Division of Economic and Risk Analysis of the US Securities and Exchange Commission, Report to Congress, *Access to Capital and Market Liquidity* (August 2017), *available at* https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf; International Organization of Securities Commissions, *Examination of Liquidity of the Secondary Corporate Bond Markets, Final Report* (February 2017), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD558.pdf.

[4] As we reported previously, the Financial CHOICE Act of 2017, as passed by the US House of Representatives on June 8, would repeal the Volcker Rule. *See* ICI Memorandum No. 30751, dated June 22, 2017, *available at* https://www.ici.org/my_ici/memorandum/memo30751.

[5] Department of the Treasury, OCC, *Proprietary Trading and Certain Interests in and Relationships with Covered Funds (Volcker Rule); Request for Public Input*, 82 Fed. Reg. 36692 (August 7, 2017), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-08-07/pdf/2017-16556.pdf.

[6] The Notice inquires, among other things, how the rule could provide a carve-out from the definition of "banking entity" for certain controlled "foreign excluded funds." Notice at 36695. These funds are discussed further below.

[7] In addition to the OCC, these agencies include the Board of Governors of the Federal System (Federal Reserve Board), Federal Deposit Insurance Corporation (FDIC), Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC).

[8] The Statement is *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf.

[9] The Statement defines "qualifying foreign excluded fund" for this purpose as "an entity that (1) is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (2) would be a covered fund were the entity organized or established in the United States, or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments; (3) would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the entity; (4) is established and operated as part of a bona fide asset management business; and (5) is not operated in a manner that enables the foreign banking entity to evade the requirements of [the Volcker Rule] or implementing regulations."

[10] US Department of the Treasury, *A Financial System That Creates Economic Opportunities, Banks and Credit Unions* (June 2017) ("Treasury Report"), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

[11] The report specifically recommends providing an exemption from the Volcker Rule's definition of "banking entity" for foreign funds owned or controlled by a foreign affiliate of a US bank or a foreign bank with US operations. Treasury Report at 78.
